DuluxGroup Limited

ABN 42 133 404 065

ASX Announcement

17 March 2015

DULUXGROUP SUPPLY CHAIN INVESTMENTS

DuluxGroup today announced two significant supply chain investments:

- the construction of a new state-of-the-art factory in Melbourne to make water-based decorative paints ("new paint factory"); and
- the establishment of a new, purpose-built distribution centre in Sydney, replacing two existing distribution centres ("new distribution centre").

New Paint Factory

The new paint factory will produce nearly all of Dulux Australia's water-based decorative paints, which are currently manufactured at the Rocklea factory in Queensland. The Rocklea factory will be retained, but will operate at a reduced manning level, focusing on the production of solvent-based decorative paint products.

It is expected that the new paint factory will cost approximately $165m, though after taking account of capital expenditure savings at Rocklea and elsewhere in DuluxGroup, together with the expected sale of the Glen Waverley site, the net expenditure will be approximately $130m, spread over the next three years. Unfortunately, the reduced activity at Rocklea will result in some redundancies. A provision of approximately $9m will be recognised in FY15, with payment in FY17 or FY18 once the new site is fully operational.

Planning for the new factory is well-advanced, with construction expected to commence late in calendar 2015 and completion targeted for late in calendar 2017. A 17 hectare site north of Melbourne has been secured.

This investment will deliver significant financial and operational benefits to the business. Cost savings will be achieved through automation, better raw material utilisation and freight savings. In addition, a planned program of capital expenditure to upgrade Rocklea to support the company's significant volume growth will be avoided. From an operational perspective, the new factory will enable the company to produce more advanced paint products using evolving higher technology resins with even greater levels of quality and consistency.

Importantly, this investment will significantly reduce the current risk of our water-based paint manufacture being interrupted by fire (due to the current co-location at Rocklea with solvent-based paint manufacture) or flood (as demonstrated by the 2011 floods at Rocklea which significantly impacted operations).

Under base case assumptions and assuming no revenue upside, the cost and capital savings result in an at least **neutral NPV** outcome.

DuluxGroup Managing Director Patrick Houlihan said that the new paint factory was an important investment that would set up DuluxGroup's Australian decorative paints business for decades.

“We’ve spent considerable time evaluating various options drawing on expertise from the global paint industry. The new paint factory is by far the most compelling option strategically, operationally and financially, delivering a solid financial return, primarily through operating cost and capital savings.

“Our Dulux paints business is world class on any measure. This investment further strengthens our product quality, innovation, customer service and cost competitiveness.

“We also greatly appreciate the support of the Victorian Government for this significant investment in manufacturing.”

New Distribution Centre

A new distribution centre will be established in Sydney to replace Dulux’s NSW distribution centre at Padstow and Selleys’ national distribution centre at Moorebank, NSW, both of which are currently operated by DuluxGroup. The new distribution centre will be built, owned and operated by Linfox, to DuluxGroup’s specification. DuluxGroup has been successfully operating in partnership with Linfox under a similar arrangement at its Dulux distribution centre in Victoria.

The key driver of this change is the significant growth in volume for both Dulux and Selleys over recent years, with both businesses now having outgrown their current distribution centres.

The closure of our existing distribution centres will unfortunately result in the redundancy of roles at those sites. We will look to redeploy where possible, however there will be retrenchments. A provision of approximately $8m will be recognised in FY15, with payment in mid to late 2016 when the new distribution centre is scheduled to be operational.

This project has a strong financial payback and positive NPV, driven by lower operating costs under the new arrangement, largely due to the benefits of a single site and a reduction in future outside storage costs. In addition, the Padstow distribution centre, which is owned by DuluxGroup and is adjacent to the Selleys factory, will be freed up for other future purposes.

DuluxGroup Managing Director Patrick Houlihan said, “The new Linfox owned and operated Sydney Distribution Centre allows us to maintain and further improve our customer service levels in a cost and capital effective way, catering for the ongoing growth in our Selleys and Dulux businesses.”

Impact on DuluxGroup

Whilst the two projects involve considerable financial outlay over the next three years, they generate a financial return when compared to a steady state “do nothing” scenario. Assuming our base case cost savings, and excluding any revenue upside, the key financial metrics for the two projects combined are as follows:

- NPV is expected to be positive;
- EBIT impact is expected to be positive once both projects are fully operational, with operating cost savings more than offsetting incremental depreciation (net of capex savings) of ~$5m p.a.;
- NPAT impact is expected to be neutral in the first full year that both projects are fully operational (FY19) and positive thereafter.

DuluxGroup’s net debt to EBITDA is expected to remain broadly in line with current levels through to completion of these projects, due to the staggered timing of the outflows and ongoing cash generation.

DuluxGroup also reinforced that it expects a dividend pay-out ratio of at least 70% of net profit after tax before non-recurring items.

DuluxGroup Managing Director Patrick Houlihan said, “We outlined at our AGM last December that, as a result of our strong organic growth in recent years, we have been assessing investment in our manufacturing and distribution assets to ensure that we can maintain and improve our industry-leading service levels, reduce our operating costs, optimise our product quality, reduce risk and support future growth.

“These two projects are important, valuable investments that significantly strengthen our business and generate a financial return. Importantly, we can deliver the projects whilst retaining the flexibility in our balance sheet to fund prudent, value adding, strategic growth opportunities that may arise.”

DuluxGroup Trading

DuluxGroup will not be discussing trading during any market communications relating to these projects. The company gave an update at the Annual General Meeting in December 2014 and will provide details on actual trading for the half year ended 31 March 2015 as part of the half year results release in mid-May.

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...\attached additional background information

Background information – Paint manufacture

Currently DuluxGroup manufactures all of its decorative paint for Australia plus some woodcare and protective coatings products at Rocklea in Queensland. Of the Rocklea-produced products, more than 80% is water-based paint (eg. Dulux Wash & Wear, Dulux Weathershield), and less than 20% is solvent-based paint (eg. Dulux Super Enamel, some woodcare products, some protective coatings products).

Rocklea is a good, efficient factory, but is more than 50 years old. We have continued to invest in filling and packaging automation, fire and explosion prevention and mitigation and various other safety and productivity initiatives to ensure that the plant runs efficiently and safely. However, emerging advanced paint technologies are more difficult to manufacture and can require a more sophisticated production process than Rocklea offers. It is increasingly difficult and expensive to further invest in modern, water-based production capability at an old operating site.

Having both solvent and water-based production in the same facility brings risk and cost. Solvent-based paint production is more fire prone than water-based paint production given the flammable nature of the solvents used and, hence, around the world solvent and water-based production is typically separated. Whilst the risk of a fire event at Rocklea is remote, the potential impact is significant, particularly given the core water-based range is produced in the same building. Further, as demonstrated by the Brisbane flood in 2011, there is a flood risk at Rocklea, albeit that the potential impact on the business is less than a significant fire.

The safety requirements of a solvent-based environment make both capital and operating costs for co-located water-based paint manufacture unnecessarily high, so significant investment in re-developing Rocklea would most likely be uneconomic.

Whilst many Australian businesses have necessarily moved manufacturing offshore, for decorative paint the relative economics of manufacturing cost versus overseas freight costs typically means that there is no economic benefit derived from moving manufacturing offshore, even before considering the operational challenges that offshore manufacture would create. This is the case in most major markets around the world.

During the evaluation phase of this project, a wide number of alternatives was considered, including doing nothing, investing in new water-based production capability at Rocklea, moving solvent-based paint manufacturing off the Rocklea site (to remove the fire risk), offshore manufacturing, and building a smaller, less automated factory. Based on a balanced view of financial, operational and strategic perspectives, none of these alternatives was compelling.

Key financial metrics

1. **New Paint Factory**

- Capital expenditure of approximately $165 million, inclusive of capitalised interest through the construction phase
- The capital expenditure will be partially offset by capital expenditure savings at Rocklea and other parts of DuluxGroup over the next three years, together with the sale of DuluxGroup's Glen Waverley site
- Net capital outflow (over and above DuluxGroup's base maintenance capex of ~$30m per annum) is expected to be approximately $130 million over the next three years, broadly phased as follows:
  - FY15 - $25m
  - FY16 - $50m
  - FY17 - $55m

- Provision of ~$9m recognised in FY15 (inclusive of discounting, with unwinding in FY16 and FY17 through interest leading to an overall total of ~$12m)
- Some relatively minor commissioning costs are expected prior to opening, which DuluxGroup would aim to absorb
- Overall project is at least NPV neutral under base case assumptions, with benefits due predominantly to operating cost savings and future capex savings
- Potential for revenue upside has not been built into the base case
- The new factory will be the largest coatings plant in Australia and New Zealand, with full capacity in excess of 100 million litres per year, which is approximately double Dulux's current volume

2. New Distribution Centre

- Provision of ~$8m recognised in FY15 (inclusive of discounting, with unwinding in FY16 through interest leading to an overall total of ~$9m)
- There will be some minor set-up costs in FY16, which DuluxGroup would aim to absorb

Potential risk factors

- Both projects are dependent on planning approval, though we are in close contact with the relevant authorities and early indications are positive
- The detailed design of the new paint factory is well-advanced, with quotes received for a significant proportion of the project cost. Some FX exposure exists on foreign-sourced components and, where possible, this will be hedged as soon as practical